Executive Summary*

Over the next few years, a wave of commercial real estate loan failures could threaten America's already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.

Commercial real estate loans are taken out by developers to purchase, build, and maintain properties such as shopping centers, offices, hotels, and apartments. These loans have terms of three to ten years, but the monthly payments are not scheduled to repay the loan in that period. At the end of the initial term, the entire remaining balance of the loan comes due, and the borrower must take out a new loan to finance its continued ownership of the property. Banks and other commercial property lenders bear two primary risks: (1) a borrower may not be able to pay interest and principal during the loan's term, and (2) a borrower may not be able to get refinancing when the loan term ends. In either case, the loan will default and the property will face foreclosure.

The problems facing commercial real estate have no single cause. The loans most likely to fail were made at the height of the real estate bubble when commercial real estate values had been driven above sustainable levels and loans; many were made carelessly in a rush for profit. Other loans were potentially sound when made but the severe recession has translated into fewer retail customers, less frequent vacations, decreased demand for office space, and a weaker apartment market, all increasing the likelihood of default on commercial real estate loans. Even borrowers who own profitable properties may be unable to refinance their loans as they face tightened underwriting standards, increased demands for additional investment by borrowers, and restricted credit.

Between 2010 and 2014, about $1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present ―underwater" – that is, the borrower owes more than the underlying property is currently worth. Commercial property values have fallen more than 40 percent since the beginning of 2007. Increased vacancy rates, which now range from eight percent for multifamily housing to 18 percent for office buildings, and falling rents, which have declined 40 percent for office space and 33 percent for retail space, have exerted a powerful downward pressure on the value of commercial properties.

The largest commercial real estate loan losses are projected for 2011 and beyond; losses at banks alone could range as high as $200-$300 billion. The stress tests conducted last year for

*The Panel adopted this report with a 5-0 vote on February 10, 2010.

19 major financial institutions examined their capital reserves only through the end of 2010. Even more significantly, small and mid-sized banks were never subjected to any exercise comparable to the stress tests, despite the fact that small and mid-sized banks are proportionately even more exposed than their larger counterparts to commercial real estate loan losses.

A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American. Empty office complexes, hotels, and retail stores could lead directly to lost jobs. Foreclosures on apartment complexes could push families out of their residences, even if they had never missed a rent payment. Banks that suffer, or are afraid of suffering, commercial mortgage losses could grow even more reluctant to lend, which could in turn further reduce access to credit for more businesses and families and accelerate a negative economic cycle.

It is difficult to predict either the number of foreclosures to come or who will be most immediately affected. In the worst case scenario, hundreds more community and mid-sized banks could face insolvency. Because these banks play a critical role in financing the small businesses that could help the American economy create new jobs, their widespread failure could disrupt local communities, undermine the economic recovery, and extend an already painful recession.

There are no easy solutions to these problems. Although it endorses no specific proposals, the Panel identifies a number of possible interventions to contain the problem until the commercial real estate market can return to health. The Panel is clear that government cannot and should not keep every bank afloat. But neither should it turn a blind eye to the dangers of unnecessary bank failures and their impact on communities.

The Panel believes that Treasury and bank supervisors must address forthrightly and transparently the threats facing the commercial real estate markets. The coming trouble in commercial real estate could pose painful problems for the communities, small businesses, and American families already struggling to make ends meet in today's exceptionally difficult economy.

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This month‘s report also includes a brief summary of the status of the disposition of the warrants that Treasury has acquired in conjunction with its TARP investments in financial institutions. The Panel had conducted its own review of the initial results of Treasury‘s repurchases of warrants in its July Report (*TARP Repayments, Including the Repurchase of Stock Warrants)* and called for greater disclosure concerning Treasury‘s warrant disposition process and valuation methodology. In January, Treasury published its first report on the warrants. Treasury‘s warrant sales receipts up to this time total just over $4 billion, which is slightly more than Treasury‘s own internal model estimates their value, but slightly below (92 percent) the

Panel's best estimate. The Panel now projects receipts from the sale or auction of TARP warrants – both those sold or auctioned to date and those yet to be disposed of – will total $9.3 billion.